The Importance Of Falling US Mortgage Rates

By Tan Kai Xian

US mortgage rates have eased slightly in the last six months, with the average interest rate on 30-year fixed-rate mortgages falling 70bp from 7.1% to 6.4%. Arguably that's no big deal, given the rate is still more than double its level at the beginning of 2021. But moderating inflationary pressure, the probability of a pause (at least) in the Federal Reserve's rate-hike cycle and an unusually wide spread between US mortgage rates and the 10-year US treasury yield all suggest that mortgage rates will fall further in the near term.

A continued decline in mortgage rates will have two important macro implications. First, lower mortgage rates will encourage more borrowers to refinance, which will accelerate the decline in holdings of mortgage-backed securities on the Fed's balance sheet. Second, lower mortgage rates will improve housing affordability.

The reasons to expect a further decline in mortgage rates have strengthened in recent weeks.

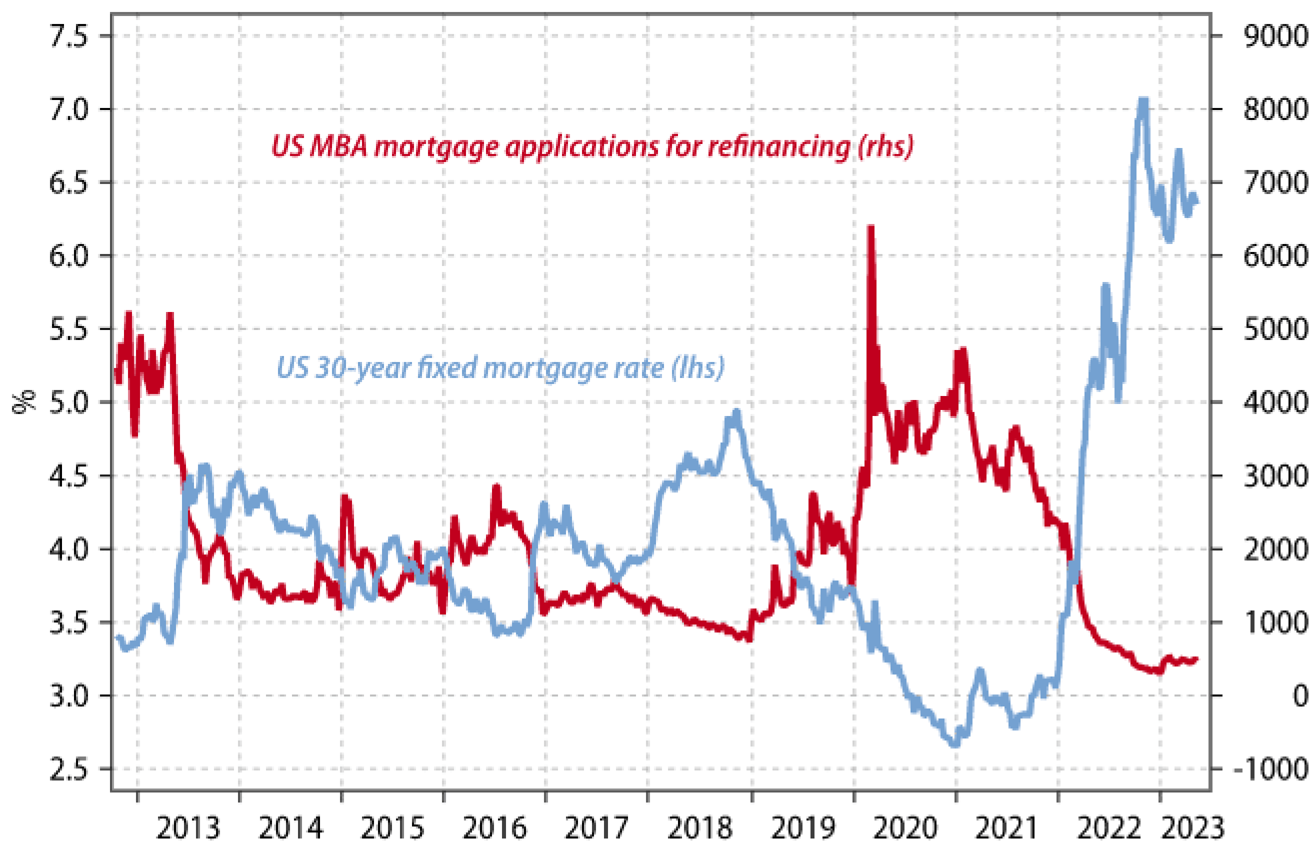
1. **The probability has risen that US consumer inflation will fall to the Fed's 2% target** in the near term (see **The Assault On Structural Inflation**). Producer price inflation has already dropped from its March 2022 peak of 11.7% YoY to reach 2.3% in April 2023, and US import prices are deep in deflation. Today, the main factor supporting consumer inflation at April's 4.9% rate is rental inflation. However, the rental component of CPI eased in March and April, and the Zillow rent index suggests a steeper decline in rental inflation lies ahead.

   As measured inflation moderates, it becomes more likely that inflation expectations will remain anchored at around 2%. This will reduce the potential upward pressure on nominal interest rates, including mortgage rates.
2. **The Fed's rate-hike cycle is probably over already** (and if not it will likely end in June). The Fed's dot plot suggests that if the economy follows the trajectory that FOMC members expect, the Fed will not raise interest rates again in 2023. However, the Fed may well have overestimated the strength of the US economy. If so, it could find it needs to ease monetary policy in the second half of the year (see **The Fed's Non-Response**). Either way, the diminished chance of further interest rate hikes reduces any upward pressures on mortgage rates.
3. **The spread between 30-year mortgage rates and the benchmark 10-year US treasury yield is abnormally wide** by historical standards. This means that even if the 10-year US treasury yield falls no further from current levels, there will still be scope for mortgage rates to decline. And if inflation moderates and the Fed eases in the second half, as Will Denyer and I expect, 10-year treasury yields could fall steeply, which means mortgage rates will be likely to fall even more steeply.

Falling mortgage rates are likely to have two major macro implications. First, the run-off rate of MBS holdings on the Fed's balance sheet will accelerate. The Fed has decreed that it will reduce its holdings of agency debt and MBSs by up to US$35bn per month as securities mature. So far in 2023, however, the Fed's holdings have been falling at a relatively modest average rate of US$16.2bn per month, as most of the MBSs sitting on the Fed's balance sheet have long maturities. But when mortgage rates fall, refinancing picks up as borrowers retire expensive

mortgages to lock in cheaper rates. These prepayments will reduce the value of outstanding MBSs on the Fed's balance sheet, accelerating the rate at which its holdings diminish. As a result, lower mortgage rates will accelerate the pace of quantitative tightening.

If this happens at the same time as a debt ceiling deal allows the US Treasury to rebuild its cash balances (see **Debt Ceiling Games**), the combination of these two factors will drain liquidity from the system at a much faster rate.



Second, lower mortgage rates will boost housing affordability. To be clear, following the sharp rise in mortgage rates in 2022, US housing affordability is exceptionally poor by historical standards. All else equal, US 30-year mortgage rates would have to fall by around 400bp for US housing affordability to return to its 20-year median. So while any decline in mortgage rates will support residential construction and sales at the margin, it would need a deep fall in mortgage rates to reverse the current housing slump. Wednesday's releases of April data for mortgage applications and building permits show no signs of this yet.

Nevertheless, investors should monitor the MBA's weekly releases of data on mortgage applications for refinancing and indexes of home purchases. Increased refinancing will point to faster QT and an accelerated drain in liquidity. Rising home purchase indexes will support US housing construction and sales. Historically, mortgage applications for refinancing tend to be more reactive to lower mortgage rates than purchase applications. This time is unlikely to be different.